DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

PETITION OF

BOSTON EDISON COMPANY

CAMBRIDGE ELECTRIC LIGHT COMPANY

COMMONWEALTH ELECTRIC COMPANY

AND

COMMONWEALTH GAS COMPANY

FOR APPROVAL OF RATE PLAN

D.T.E. 99-19

DIRECT TESTIMONY OF

THOMAS J. FLAHERTY

EXHIBIT TJF-1

TABLE OF CONTENTS

EXHIBITS

EXHIBIT TJF-2	Summary of Regulated Utility Experience
EXHIBIT TJF-3	Merger Savings Summary
EXHIBIT TJF-4	Costs to Achieve
EXHIBIT TJF-5	Supporting Workpapers

I. INTRODUCTION AND QUALIFICATIONS

Q. Please state your name and by whom you are employed.

A. My name is Thomas J. Flaherty, and I am the National Partner - Energy Consulting and a partner in the Deloitte & Touche Consulting Group LLC ("Deloitte Consulting"), a Delaware limited liability corporation. My business address is 2200 Ross Avenue, Suite 1600, Dallas, Texas 75201.

Q. Would you briefly summarize your academic and professional background?

A. I graduated from the University of Oklahoma with a B.B.A. degree in Accounting and immediately joined Touche Ross, where I have been continuously employed since 1973. In December 1989, Touche Ross and Deloitte, Haskins & Sells merged and now conduct business under the firm name of Deloitte & Touche LLP. Since joining Touche Ross, I have specialized in the public utility industry and have performed a variety of assignments.

I have assisted managements from a number of electric and/or gas utilities in their identification, evaluation and integration of acquisitions, including: screening analysis; review of corporate restructuring alternatives; assessment of merger-related cost reduction opportunities; development of regulatory strategies; planning and execution of merger integration; and, assignment and allocation of costs and benefits related to mergers and acquisitions. In addition to my involvement in merger and acquisition consulting for Deloitte Consulting, I have participated in numerous other utility consulting engagements in the areas of corporate growth, diversification, restructuring, organizational analysis, business process reengineering, benchmarking, strategic planning, strategic marketing, litigation assistance, economic feasibility studies, regulatory planning and analysis and financial analysis.

I also have conducted or directed similar assignments for a variety of industries, including construction, retailing, publishing, health care, real estate and manufacturing, in addition to utilities. Exhibit TJF-2 to this testimony details my experience with regulated utilities.

Q. **Please summarize your experience in utility mergers and acquisitions.**

A. I have been involved in more than 100 actual, proposed or potential transactions involving electric, electric and gas combination, or gas utilities. I have experience working for both buyers and sellers and have assisted client managements in their assessment of a broad range of transactional issues, including the following:

- Target analysis
- Asset quality analysis
- Customer analysis
- Competitor analysis
- Synergy assessment
- Financial analysis
- Transaction structuring
- Regulatory strategy
- Testimony
- Integration planning

The publicly announced transactions in which I have been significantly involved, other than the one that is the subject of this proceeding are: Kansas Power & Light and Kansas Gas and Electric, IPALCO Enterprises and PSI Resources, Entergy and

Gulf States Utilities, Southern Union and Western Resources (Missouri properties), Washington Water Power and Sierra Pacific Resources, Midwest Resources and Iowa-Illinois Gas & Electric, Northern States Power Company and Wisconsin Energy Corporation, PECO Energy Company and PPL Resources, Public Service Company of Colorado and Southwestern Public Service Company, Baltimore Gas & Electric and Potomac Electric Power Company, Delmarva Power and Atlantic Energy, WPL Holdings, IES Industries and Interstate Power, Puget Sound Power & Light and Washington Energy, TU Electric and ENSERCH, Western Resources and Kansas City Power & Light, Western Resources and ONEOK, Inc. (Kansas, Oklahoma gas properties), Houston Industries and NORAM Energy, Ohio Edison and Centerior, ENOVA and Pacific Enterprises, Brooklyn Union Gas and Long Island Lighting, Allegheny Energy and DQE, Inc., LG&E Energy and KU Energy, NIPSCO Industries and Bay State Gas, American Electric Power and Central and SouthWest Corporation, and Sierra Pacific Resources and Nevada Power.

Q. **Do you hold any professional certifications?**

A. Yes. I am a Certified Management Consultant and a member of the Institute of Management Consultants.

II. PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. I have been asked to appear for BEC Energy Company ("BEC Energy") and Commonwealth Energy System ("COM/Energy") (collectively, the "Companies") in support of the rate plan filings of Boston Edison Company ("Boston Edison"), Cambridge Electric Light Company ("Cambridge"), Commonwealth Electric Company ("Commonwealth Electric") and Commonwealth Gas Company ("Commonwealth Gas"). Deloitte Consulting assisted the managements of both Companies in their identification and quantification of potential cost savings resulting from the merger.

In this testimony I: (1) describe the categories of cost savings that are estimated by the managements of BEC Energy and COM/Energy to result from the merger of the Companies; (2) provide management's basis for its quantification of estimated cost savings; (3) describe the process by which such identified cost savings categories and estimated cost savings were derived by the Companies, and; (4) compare the level of cost savings identified in this merger with other transactions with which I am familiar.

Q. Have you included any exhibits to your testimony?

A. Yes. Exhibit TJF-2 is a summary of my experience with regulated utilities, Exhibit TJF-3 provides a ten-year summary of potential merger cost savings, and Exhibit

TJF-4 provides a detailed breakdown of potentially incurred costs to achieve the identified merger savings. Exhibit TJF-5 contains supporting workpapers for the savings and costs to achieve set forth in Exhibits TJF-3 and TJF-4.

III. SUMMARY OF TESTIMONY

Q. Please summarize your testimony.

A. The merger of the Companies is anticipated to result in cost savings that will permit rates in the future to be below the level that otherwise would have been necessary on a stand-alone basis for Boston Edison, Cambridge, Commonwealth Electric or Commonwealth Gas. The approximately $667 million of estimated cost savings, before approximately $111 million of out-of-pocket costs to achieve these savings and $24 million of cost-cutting measures planned or initiated prior to the merger (premerger initiatives), is expected by management of BEC Energy and COM/Energy to provide an opportunity to benefit all stakeholders, including customers, shareholders and employees, and result in a stronger, more competitive company.

These savings, by area, are identified further below:

Total Cost Savings

Savings Category		2000 - 2009 ($ Millions)
Corporate and Operations Support Staffing		$403
Corporate and Administrative Programs		211
Purchasing Economies (Nonfuel)		46
Energy Sourcing		7
	Total Savings	667
Less:	Costs to Achieve	(111)
	Premerger Initiatives	(24)
	Net Savings	$532

The estimated cost savings referenced above reflect only merger-related savings. They reflect the consensus of both Companies and were jointly developed by management of the Companies, with the assistance of Deloitte Consulting. This joint management development of merger-related cost savings provides a sound basis for identification and quantification and results in well-documented, thoughtfully considered savings components. As a result, the process utilized by the Companies was comprehensive and captures all significant sources of merger savings typically available.

The estimated cost savings reflect the potential creation of cost-reduction or cost-avoidance opportunities through the ability to consolidate separate, stand-alone operations into a single entity. This consolidation and integration thus may enable duplicative functions and positions to be eliminated; similar corporate activities to be combined, avoided or reduced in scope; external purchases of commodities and services to be aggregated; and capital expenditures to be avoided.

Based on my experience in other mergers and on my direct involvement with the identification, evaluation, and quantification efforts related to estimated cost savings in this and other transactions, the process utilized by the Companies for estimating potential merger cost savings was consistent with the process utilized by other companies in previous merger transactions. As a result, I believe the approximate level of merger savings identified by the Companies is reasonably attainable over a ten-year period beginning shortly after the consummation of the merger, provided that management of the combined company executes its integration plans in a manner consistent with its intent and how other utilities have pursued similar opportunities. The identified merger cost savings are also within the broad range of those developed by other companies in other similar situations.

Recent utility mergers and acquisitions in other states have produced substantial benefits to customers in the form of operational synergies and cost savings that reduce rates or slow the rate of growth in rates. Benefits to customers, however, will not materialize without costs being incurred. It is a well-established regulatory principle that, to reflect the shareholders' willingness to fund the costs necessary to realize potential cost savings, the costs to achieve both these savings and the underlying transaction should be fully recovered.

IV. SCOPE OF ANALYSIS

Q. What process was utilized by the Companies in developing the cost savings associated with the proposed merger?

A. The process began by collecting appropriate raw data regarding operations. The sources of this data included both public and private information. This information encompassed geographical and operational data; included numbers of positions, the various departments they worked in, their location, their salaries and benefits; and included other applicable information.

Next, the Companies, with the assistance of Deloitte Consulting, identified individual cost categories, including the actual past and expected future expenses for each individual category. Information used to accomplish this process included company contractual information, various departmental reports, forecasts, and budgets, as well as departmental operating plans.

General operational philosophies for each company were also identified. As part of this process, potential organizational and operational approaches were discussed and areas for potential savings were identified, with the assistance of Deloitte Consulting.

This process resulted in the development of a set of area-by-area operating assumptions.

Finally, from all of the information and analyses identified above, savings estimates were developed, reviewed, analyzed, and revised by the managements, with the assistance of Deloitte Consulting, to produce the level of estimated savings reflected in my testimony.

Q. What was the scope of the assistance provided by Deloitte Consulting related to the synergy savings associated with this proposed merger?

A. Deloitte Consulting was asked to assist the managements of the Companies in the identification and quantification of both potential savings and additional costs necessary to realize those savings associated with the merger. This assistance was based upon previous experience and included assistance in the identification of necessary data elements and potential cost savings areas, discussion of potential organizational and operational philosophies, discussion of potential assumptions to be utilized by the Companies, assistance in the identification of estimated savings and costs to achieve and comparison of results to other previous transactions.

Q. Was Deloitte Consulting retained to provide any other services in connection with the merger?

A. Yes. Deloitte Consulting was also engaged (i) to provide testimony in this proceeding and (ii) to assist the Companies in integrating BEC Energy and

COM/Energy into a combined operating entity once the proposed merger is consummated.

Q. What personnel from the management of the Companies was involved in this process?

A. A number of both senior management personnel, as well as middle management personnel from both companies, were actively involved in the cost-savings identification and quantification described above.

Q. Is this process typical of other cost-saving estimation processes that you have been engaged in?

A. Yes, the overall process undertaken by the Companies to identify cost savings was typical of other engagements that I have been involved in, and captures all significant sources of merger savings typically available.

Q. How were the cost savings quantified in this process?

A. Estimates of cost savings were developed on a nominal cost basis over a ten-year period commencing six months after the consummation of the merger. The attached exhibits reflect projected savings for calendar years 2000 through 2009, based on the assumption that the merger will occur on July 1, 1999. If the merger occurs before or after that date, the timing of the projected savings would be adjusted accordingly. This provides a long-term view of attainable savings. This ten-year period is the same period traditionally utilized by regulatory commissions with respect to review of merger cost savings.

Q. Are the identified cost savings attainable only during this ten-year period?

A. No. The majority of the identified savings components would generate benefits that will continue well beyond this period. For example, potential labor position reductions associated with the merger will be permanently eliminated since they relate to redundant functions. Likewise, potential purchasing leverage benefits will continue indefinitely as the cost of materials and supplies acquisition is reduced. The terminal value of the post-ten-year savings is significant, and usually exceeds the ten-year savings level by a large amount.

Although the cost savings estimated for the ten-year period generally would continue into future periods, cost savings are presented in nominal dollars consistent with the ratemaking process and are limited to the first ten years following the merger.

Q. What methods were used to quantify the individual cost savings components?

A. Cost savings were developed using three principal methods of quantification:

- Direct analysis - Use of actual costs and changes to these costs based on planned consolidation activities, e.g., position reductions were estimated based on detailed analyses of fully aligned individual functions and positions.
- Estimation - Determination, based upon more limited analysis of actual data, of potential merger-related cost reduction considering anticipated changes to markets

and operations (e.g., reduction in materials and supplies costs from additional volume buying).

- Comparison to other transactions - Utilization of expectations in other proposed utility mergers as a proxy for the Companies' impacts (e.g., shareholder services expense reductions based on expected or realized reductions achieved by other companies).

Of the three methods, the majority of the savings were quantified by using direct analysis. These methods of quantification are consistent with those utilized by other utility companies in prior mergers. For example, it is well recognized that materials and supplies costs will be reduced from a merger; however, the actual amount of the reduction will not be known until negotiations with suppliers and vendors are finalized. Using other expected or realized reduction amounts is an appropriate method for quantification pending such negotiation.

Q. **Is the savings analysis predicated upon any particular organizational structure?**

A. No. However, the cost savings related to the integration of common functions are predicated upon centralization of these functions, where appropriate and practical. This centralization could occur in several ways: within an expanded headquarters organization; within a corporate services entity, or by a combination or centralization of corporate and administrative-type services and decentralization of common technical support services into operating units. Any of these approaches would provide the Companies an opportunity to realize merger cost savings in those affected (and related) areas.

In quantifying cost savings, the maximum extent of centralization that appeared practical was assumed, without creating an ineffective, bureaucratic, and costly organization. This approach assumes that common corporate and administrative functions would generally be centralized in a service company, with common technical support or "mission critical" administrative functions either similarly centralized, or located as required within the various operating units. COM/Energy already operates in a service company environment that provides a model for implementation. Given the proximate geographic coverage of the Companies, and the concentration of resources within centralized groups, it is likely that the majority of these support functions, e.g., budgeting, will be located within a single centralized entity.

Q. Can the level of savings estimated by the Companies and reflected in your testimony be achieved?

A. The process utilized by the Companies for estimating potential merger cost savings was consistent with that utilized by other companies in previous merger transactions. As a result, the savings levels are reasonably attainable, provided that management of the combined company executes its integration plans in a manner consistent with its intent and how other utilities have pursued similar opportunities.

V. BENEFITS CREATED FROM UTILITY MERGERS

Q. In general, how are savings created from the combination of two utilities?

A. The combination of two utilities enables the succeeding company to realize substantial benefits in the form of economies, efficiencies and operating effectiveness. These synergies relate to a variety of operational functions and potentially will result in benefits that will accrue to customers. These potential savings areas are viewed as directly attributable to the merger and are not attainable in the absence of the merger.

Q. Are there different types of cost savings that can result from the combination of two utilities?

A. Yes. In identifying potential cost savings, only those opportunities that are directly related to the merger were quantified. The distinction between merger and non-merger-related savings is highlighted below:

- Created savings - These are savings that are directly related to the completion of a merger and could not be obtained absent the merger. For example, the reduction of total cost through the avoidance of duplication or overlap and the ability to extend resources over a broader base of activity would naturally occur through the consolidation of similar functions. Without the combination, both companies would continue to expend amounts on related activities, and as a result, would incur stand-alone cost levels higher than in consolidation. The vast majority of all cost savings in this merger would be directly created by the combination.

- Enabled savings - These savings result from the acceleration or "unlocking" of certain events that could give rise to savings and therefore are considered merger savings. For example, technology differences that exist between companies may provide an opportunity to share technology and achieve productivity improvements more rapidly and more cheaply than would have occurred on a stand-alone basis. For example, one company that has adopted an enterprise-wide information system will likely enjoy more seamless operation and management and higher productivity than a company that has individual, customized packaged applications. While the company without the integrated technology environment can obtain such productivity benefit from independent investment, the merger enables an existing technology environment to be more rapidly deployed and costly stand-alone investment and concept feasibility analysis to be avoided. Very little of the estimated savings in this merger might be considered enabled.

- Developed savings - Reductions in cost due to management decisions that could have been made on a stand-alone basis are unrelated to the merger. A decision to reengineer an organization will result in reduced costs but likely would have been achieved without the merger. None of the cost savings in this merger is in this category.

Q. What types of savings have been quantified with respect to the BEC Energy and COM/Energy merger?

A. The quantification effort focused on merger-related savings only, <u>i.e.</u>, those savings that would not be attainable but for the combination of the two companies. The savings described in my testimony almost exclusively fall under the "created savings" category described above. Potential areas of benefit, and subsequently the resulting cost savings, are determined to be merger-related if they are not attainable by any action that management of either company could practically initiate on an independent basis. For example, management of either company could reduce labor costs by eliminating positions as part of a resource and function analysis. These reductions, however, would relate solely to that entity's independent operations.

Merger-related savings quantified result only from action taken by management in association with the combination of BEC Energy and COM/Energy: for example, the fact that both companies maintain separate tax activities provides an opportunity to consolidate these functions and avoid replication. This integration of similar functions and activities would not be possible without the merger of BEC Energy and COM/Energy. Thus, the benefits identified are only those believed to be directly attributable to the merger. Additionally, cost savings or cost avoidances that result from the new size and economic scope of the combined entity are merger-related. For example, routine activities that could not be economically outsourced by either company individually may now be candidates for outsourcing, given the new combined entity's greater volumes. Similarly, activities that either of the Companies now outsource might be performed more cost-effectively internally by the combined entity where volumes now justify specialized resources. The greater size of the combined entity should also enable it to be a more cost-effective purchaser of various products and services. Further, to the extent that the combination of two Companies enables the Companies to reduce costs by transferring technology or competencies to each other, these benefits are also merger-related if such actions could not have been effectively implemented by the Companies independently, or if such transfers enable operating costs to be reduced more rapidly or to a lower level than otherwise would have been the case.

Each of the examples described above, as well as other additional cost savings or cost avoidances that are directly attributable to the merger, is considered merger-related synergies. Conversely, cost savings or avoidances that would have occurred even in the absence of the merger are not merger-related and should not be included in a calculation of the savings attributable to the merger.

Q. **How do savings result from the typical combination of two utilities?**

A. Savings developed reflect those areas where the total level of costs can be affected by actions of management that are the direct result of the combination of BEC Energy and COM/Energy. These savings areas are derived from the operational synergies that are created upon integration of two independent operations. These savings areas would typically affect operations in the following ways:

- Cost reduction - The total cost of service is reduced as a result of the merger by avoiding duplication of the cost input required to achieve the same level of output. For example, similar operating functions, such as management development, could now be integrated and would require less input to achieve results on a combined basis.

- Cost avoidance - The total cost of service is reduced due to the ability to forego certain types of parallel expenditures. For example, redundant expenditures required by both entities (e.g., information systems) could be avoided by selecting one set of development efforts to eliminate duplication.

- Revenue enhancement - The creation of additional revenue streams by using existing regulated assets to supplement revenue sources could be a means to increase benefits for shareholders and customers. These revenue streams would be related directly to combining and packaging available resources, such as energy services, in a more attractive manner, i.e., to produce or increase non-regulated sales, than could be achieved independently. No such revenue enhancement opportunities were identified in this transaction.

Q. **What categories of quantifiable savings typically result from a utility merger?**

A. Quantifiable savings resulting from a merger typically can be categorized as follows:

- Corporate and Operations Support Staffing
- Corporate and Administrative Programs
- Purchasing Economies
- Energy Sourcing

Q. **Were the "costs to achieve" identified in the merger cost savings analysis?**

A. Yes. Certain costs must be incurred to facilitate the realization of the identified cost savings. Costs to achieve are an inherent component of any merger transaction and are necessary to complete a transaction successfully and/or produce the level of intended benefits. These costs to achieve are cash expenditures that are directly related to pursuing or executing the transaction and have the effect of reducing the level of distributable benefits. Were the total cost savings to be distributed without full recognition of these costs to achieve, the utilities would in effect be distributing a greater level of savings than in fact exist. In addition, if these out-of-pocket costs are not recoverable in rates, the Companies would effectively be required to support such expenditures without compensation. This would mean that customers would be compensated without any recognition of the costs to achieve those savings. Thus, to be equitable to all parties, it is only the net level of savings that is available for use by the Companies. In all utility merger transactions of which I am aware, costs to achieve have been considered and recognized in determining the net level of benefits available to customers and shareholders.

VI. COMPARISON TO OTHER TRANSACTIONS

Q. Are the categories of savings in this merger consistent with those typically identified in utility combinations?

A. Yes, they are. There are, however, certain factors unique to this merger that affect the nature and level of synergies available.

Q. Please elaborate on these factors.

A. Several factors typically affect the nature and level of merger synergies expected in utility combinations. These include: relative size (of the companies), relative cost position, location, capacity position, and organization and management philosophy. Certain of these factors affect the quantified merger synergies in this merger:

- First, there is a limited amount of overlapping service territories between the electric operations of BEC Energy and the gas operations of COM/Energy in the Framingham and Western Boston metropolitan area. Overlapping service territories provide additional savings opportunities, e.g., reduction in facilities and sharing of resources. However, the closely proximate service territories of Boston Edison and Cambridge do allow for some facilities concentration;

- Second, BEC Energy's electric operations are larger than COM/Energy's, which also affects the level of merger savings as scale differences can limit the extent of synergies available through combination. For example, in these instances where BEC Energy has significantly more resources dedicated to a function than would COM/Energy, such as human resources, the impact of resource overlap would be limited by the smaller size of COM/Energy. Two more evenly sized companies may experience relatively greater resource reduction opportunities since resource levels are more equivalent. In this case, one partner devotes relatively fewer resources to certain functions. As a result, resource overlap is lower than for two more equally sized companies;

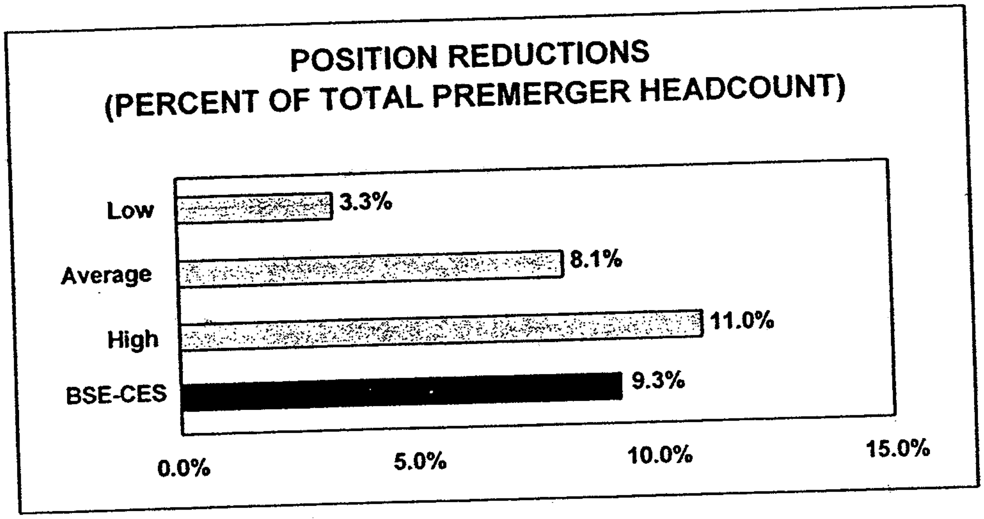
- Third, both BEC Energy and COM/Energy are divesting their generation assets. This eliminates any savings in the generation and generation support areas, since generation will no longer exist in the new combined company. For most merging utilities, such disaggregation has not taken place;

- Fourth, only COM/Energy has gas operations; Boston Edison is an electric-only company. Since both companies do not have gas operations, there is no overlap or duplication in the gas operations areas and therefore no opportunity for cost reduction as in many previous mergers;

- Finally, BEC Energy and COM/Energy headquarters are approximately two miles apart. This distance decreases the complexity of combined operations and can serve to maximize the level of savings available compared to two less closely proximate companies.

Q. How do the BEC Energy-COM/Energy merger cost savings compare to those in other transactions?

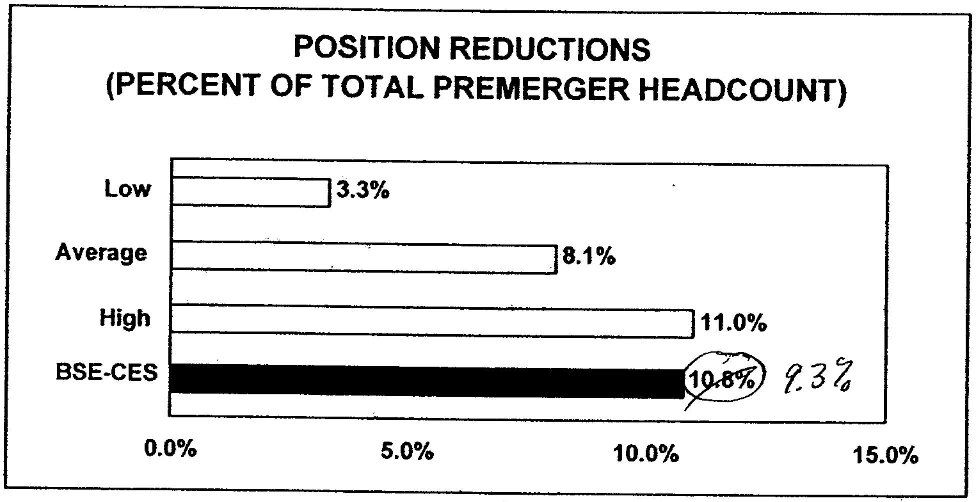
A. The anticipated synergies from the merger of BEC Energy and COM/Energy are within the range identified by other companies in other recent utility mergers, although they fall at the high end of the range for both position reductions and nonfuel operating and maintenance ("O&M") cost savings. In particular, anticipated position reductions and nonfuel O&M expense reductions were reviewed -- two categories that provide a useful basis for comparative assessment of relative merger-related synergies. As indicated in the table immediately below, the position reductions that could result from this merger are above the average of 16 of the most recent proposed utility transactions for which relevant data is available.[1]



The 9.3% position reduction amount for the merger of BEC Energy and COM/Energy reflects the estimated total number of position reductions (362) compared to the total number of positions at both companies prior to the initiation of the merger (3,902). The 9.3% reduction amount is above the average reduction figure of 8.1%, but is explained by the overlapping operations and the geographic

1 These 16 transactions are: Washington Water Power and Sierra Pacific Resources; Midwest Resources and Iowa-Illinois Gas & Electric; Northern States Power and Wisconsin Energy; Union Electric and CIPSCO; Public Service Company of Colorado and Southwestern Public Service; Baltimore Gas & Electric and Potomac Electric Power; Puget Sound Power & Light and Washington Energy; WPL Holdings, IES Industries and Interstate Power; Western Resources and Kansas City Power & Light; Delmarva Power and Atlantic Energy; Ohio Edison and Centerior Energy; Pacific Enterprises and ENOVA; Brooklyn Union and Long Island Lighting; Sierra Pacific Resources and Nevada Power; American Electric Power and Central and South West; Allegheny Power System and Duquesne Power and Light; and, LG&E Energy and KU Energy. The data I have presented are based upon estimated synergies.

reductions that could result from this merger are above the average of 16 of the most recent proposed utility transactions for which relevant data is available.[1]



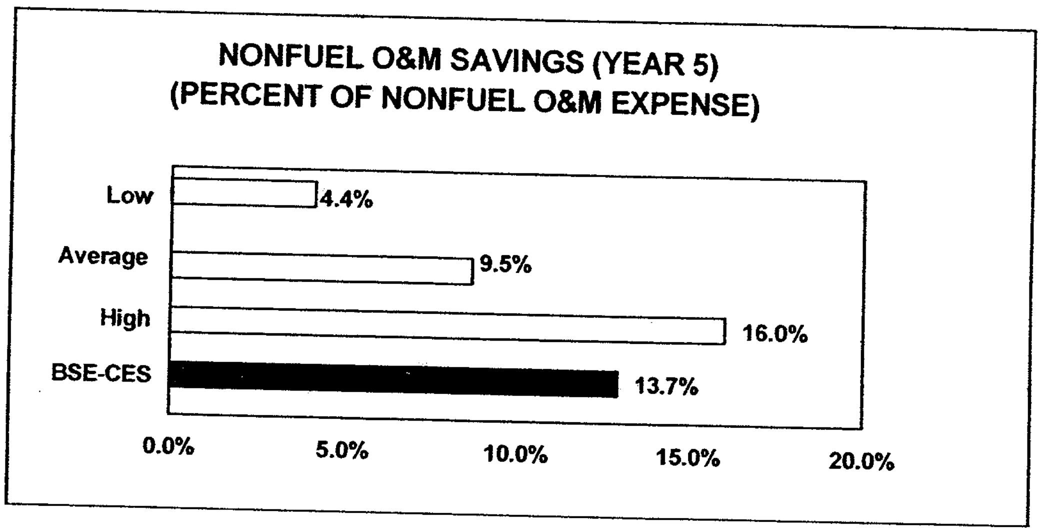
The 9.3 ~~10.8%~~ position reduction amount for the merger of BEC Energy and COM/Energy reflects the estimated total number of position reductions (362) compared to the total number of positions at both companies prior to the initiation of the merger 3,902 ~~(3,938)~~. The 9.3% ~~10.8%~~ reduction amount is above the average reduction figure of 8.1%, but is explained by the overlapping operations and the geographic

---

1 These 16 transactions are: Washington Water Power and Sierra Pacific Resources; Midwest Resources and Iowa-Illinois Gas & Electric; Northern States Power and Wisconsin Energy; Union Electric and CIPSCO; Public Service Company of Colorado and Southwestern Public Service; Baltimore Gas & Electric and Potomac Electric Power; Puget Sound Power & Light and Washington Energy; WPL Holdings, IES Industries and Interstate Power; Western Resources and Kansas City Power & Light; Delmarva Power and Atlantic Energy; Ohio Edison and Centerior Energy; Pacific Enterprises and ENOVA; Brooklyn Union and Long Island Lighting; Sierra Pacific Resources and Nevada Power; American Electric Power and Central and South West; Allegheny Power System and Duquesne Power and Light; and, LG&E Energy and KU Energy. The data I have presented are based upon estimated synergies.

proximity of the Companies.

Similarly, the nonfuel O&M reductions that will result from the merger are also above the average of the same 16 transactions.



Again, the geographic proximity between the utility operations is the principal reason for higher O&M synergies between BEC Energy and COM/Energy, and the average synergies from other recently proposed utility or utility holding company mergers. This result is also partially driven by the lack of any generation O&M expenses in the denominator, <u>i.e.</u>, no expenses in this relatively unaffected area are present to inflate the denominator. Another factor that may increase the relative BEC Energy-COM/Energy comparison against the previous transaction average is related to the premerger initiatives of the two companies. BEC Energy's and COM/Energy's planned and continuing premerger cost reduction initiatives reduce the denominator and help cause the comparison to exceed the average. Few of the other 16 transactions had any, or any significant, premerger initiatives that caused nonfuel O&M levels to be reduced. Based upon the convergent operational characteristics of BEC Energy and COM/Energy, and the broader cost reduction components typically included in either electric to electric or electric to electric/gas combination mergers, the cost savings and cost avoidances from this merger reflect those found within previous industry experience.

VII. DETAILED COST SAVINGS DESCRIPTION

A. Summary

Q. You previously testified that approximately $667 million in merger costs savings have been quantified by the Companies, prior to considering the costs to achieve. Would you identify and define the principal categories of cost savings that comprise this amount?

A. Yes. As Exhibit TJF-3 illustrates, there are four primary categories of cost savings that have been quantified. Each of these is described briefly below:

- Corporate and Operations Support Staffing - Position reductions related to redundancies associated with corporate, administrative and technical support functions.

- Corporate and Administrative programs - Reductions in nonlabor programs and expenses, such as insurance and shareholder services, resulting from economies of scale and cost avoidance.

- Purchasing Economies (nonfuel) - Aggregation of materials and supplies volumes and services contracts to increase purchasing leverage and to reduce required reorder volumes and associated carrying costs.

- Energy Sourcing - Load diversity between the two companies arising from different load and peaking characteristics allows the companies to purchase power from energy providers at a lower cost due to the increased attractiveness of the combined load profile. Aggregation of purchasing volumes also allows for increased vendor leverage given the larger total load now to be served.

Q. Are there only four categories of cost savings that have been quantified?

A. No. These categories represent only the general classification of cost savings. There are multiple, individual cost savings elements identified by management of the Companies with assistance from Deloitte Consulting that comprise these general categories. These are listed below and further illustrated in Exhibit TJF-3.

<u>Corporate and Administrative Programs</u>

- Administrative and General Overhead
- Public Relations
- Association Dues
- Benefits
- Credit Facilities
- Facilities

- Insurance
- Information Systems
- Professional Services
- Vehicles
- Shareholder Services

<u>Purchasing Economies</u>

- Procurement
- Contract Services
- Inventory Reduction

Q. **What are the categories of, and approximate costs necessary, to achieve the savings?**

A. There are several categories of costs that must be incurred to achieve the identified savings that are expected by the Companies. These costs reflect expenditures necessary to effectuate the cost savings identified from the merger through company integration. These categories of costs to achieve, as listed below, are further illustrated in Exhibit TJF-4:

- Separation Costs
- Employee Retention
- Systems Integration
- Employee Relocation
- Directors' and Officers' Tail Liability Coverage
- Regulatory Process Costs

- Internal/External Communications
- Facilities Integration
- Transition Costs
- Transaction Costs

Estimated costs to achieve total approximately $111 million, which will principally be incurred in 1999 and 2000 (see Exhibit TJF-4), but will extend over the full ten-year period to reflect certain ongoing costs.

Q. **Are there any other items that offset merger savings?**

A. Yes. Cost savings initiatives that were already planned prior to the merger were subtracted from the gross savings estimates because there is likely to be some overlap between these initiatives and identified cost savings resulting from the merger. These ongoing or future initiatives will contribute to lower total costs to customers and are estimated at $24 million over the ten-year period. The merger thus allows the Companies to achieve additional cost savings opportunities beyond those previously identified.

Q. **What is the anticipated level of total cost savings after these costs to achieve are reflected?**

A. The total estimated cost savings identified from the merger over the first ten years after the merger, after being adjusted for costs to achieve and premerger initiatives, are approximately $532 million.

B. General Assumptions

1. Escalation Rates

Q. What assumptions about the escalation of costs were utilized by the Companies in estimating cost savings?

A. For the most part, cost savings were estimated based on current cost and expense levels. To account for inflation and other economic factors appropriately, an escalation rate was then applied to year one savings levels to determine the level of savings in each of the subsequent years. Development of the estimated cost savings over the ten-year period without application of an escalation factor would result in understatement of the total cost savings available over this period. Failure to apply an appropriate escalation factor ignores year-to-year specific category inflation.

Q. Was the same escalation rate used for all savings categories?

A. No. A differential existed in the anticipated escalation rates for the cost categories contemplated in the analysis (e.g., differences between salaries and other cost categories). For this reason, a single escalation rate could not be used for all cost savings categories. Although 2.5% was used for general inflation, a higher rate (4.7%) was used for salaries to reflect market requirements. This 4.7% level is consistent with the Companies' pre-merger, stand-alone assumptions for salary increases. Further, the 4.7% is consistent with long-term national forecasts of salary escalation and historical national salary escalation. Likewise, a higher escalation rate of 4.7% was used for public relations, contract services, and professional services due to the professional labor content of those costs. Professional salary growth historically approximates the higher wage and salary escalation rate. These escalation rates are comparable to those used by other companies with which I am familiar and to other longer-term estimates for general inflation.

2. Treatment of Capital Savings

Q. **Were there other general assumptions or methodologies employed in the cost savings analysis?**

A. Yes. In treating capital deferrals and avoidance related to the merger, it would be inappropriate to count the entire amount of the capital expenditure deferred or avoided as cost savings. For example, if it were anticipated that the Companies could avoid installing a $10 million computer system in 2001, this $10 million reduction in expenditures in 2001 was not used for the actual savings. Including the $10 million as savings achieved in 2001 would not represent the avoided revenue requirements associated with that $10 million capital expenditure from either the company or customers' perspectives. Additionally, such a methodology would result in overstating the cost savings in the early years following the merger by taking credit for the entire avoided investment as cost savings in those years. Instead, it is more appropriate to reflect only the revenue requirements savings associated with capital deferral/avoidance as cost savings. The components of revenue requirements include, but are not limited to, financing, depreciation, insurance and property tax. This revenue requirements approach, rather than a cash-flow approach, provides a more appropriate determination of the savings estimated to be generated due to the merger.

Q. What methodology was used to capture these capital deferral/avoidance savings?

A. A fixed charge rate for each year of the first ten years following completion of the merger was applied to each year's capital expenditure reductions. The fixed charge rate methodology, which reflects normal declining balance ratemaking treatment, was used to estimate annual savings levels. Fixed charge rates cover depreciation, insurance, property tax, income taxes and cost of capital and were determined by both BEC Energy and COM/Energy and then were blended to determine both general rates for long-term assets and specific rates for information technology-related expenditures. The levelized fixed charge rate for capital items other than information technology was 20.02%, while the levelized rate for information technology items was 24.04%, reflecting the more rapid (six-year) depreciation period.

C. Cost Savings Summary

1. Corporate and Operations Support Staffing

Q. Please discuss in more detail the nature of the cost savings created through the integration of the corporate and operations support functions.

A The combined companies expect to integrate existing corporate, administrative and technical support areas. Such integration would generate savings through the elimination of redundant positions within both headquarters and operations support in the following types of functions:

- Legal
- Finance
- Corporate Planning
- Information Systems
- Customer Service
- Executive Management
- Systems Planning
- External Relations
- Accounting
- Human Resources
- Administrative Support
- Marketing
- Transmission & Distribution
- Technical Support

A merger between the Companies provides an opportunity to consolidate these functions and eliminate redundant activities. For example, the consolidation of two accounting departments would typically create significant savings. Potential redundancy within the two departments is identified through an alignment of functions between the Companies to ensure comparability across different organizational structures. Each individual function within the finance area, including budgets and forecasting, financial reporting, general accounting, tax accounting and accounts payable, among others, contains positions performing duplicate tasks. These overlapping positions could be eliminated without an impact on remaining workload volumes.

Q. How was this principle applied to determine the potential position savings that would result from a merger of the Companies?

A. The first step in determining corporate and operations support labor savings was to develop a detailed functional alignment of each Company. Both Companies provided organizational and functional breakdowns of their respective companies that identified each position within its respective organization. The stand-alone company functional areas then were aligned so that position levels for similar functions/activities performed by the respective companies could be compared. The analysis maintained consistency between the inter-company functional categories and aligned representative activities between the Companies.

Upon completion of the functional alignment, the position levels necessary to perform the required activities under the merged company scenario were identified. In determining the appropriate future position levels of the merged company, the following items were considered:

- Impacts of geographic distance and system size on the ongoing approach to consolidation of the Companies;
- Duplicative or redundant activities that could subsequently be eliminated;
- Differences in existing management, operational and structural philosophies;

- Need for and ability to consolidate functions in one location and the impact of using linking technologies between functions at different locations; and
- The specific cost drivers, if any, of the functional areas that would affect appropriate position requirements.

Reviews of each functional area were performed to ensure that any potential reductions did not exceed the position levels of either company on a stand-alone basis. Thus, even where significant scale differences exist, e.g., BEC Energy dedicates 50 resources to a function and COM/Energy commits only 20, reductions would be limited to the lower position level, i.e., 20 resources.

Q. **How are these corporate and operations support functions assumed to be structured to realize these positions savings?**

A. The achievement of the estimated level of savings assumes that these functions will be centralized to the extent determined most practical, effective and efficient by the Companies. The position savings identified above are predicated on the centralization of many functions into a traditional service company like those presently maintained. Decentralization of certain functions or activities into operating units may also occur on a "mission critical" basis to avoid over-centralization and provision of necessary resources to support business unit accountability.

Q. **Please describe the results of the analysis discussed above.**

A. As of January 1, 2000, BEC Energy is estimated to have a total of 2,230 positions in utility operations. As of that same date, COM/Energy is estimated to have a total of 1,506 positions devoted to utility operations. Those positions, which are field-related, are relatively unaffected for the purposes of the analysis. Examples of primarily unaffected positions include Distribution Department personnel or transmission transformer and substation maintenance crews. Thus, a large portion of the total positions that focus directly on service delivery to customers is not significantly affected by the merger and does not jeopardize safety, service quality or reliability.

In the analysis, BEC Energy had 706 positions associated with corporate and administrative functions, while COM/Energy had 463. The combined corporate and administrative positions of the two companies were thus 1,169, or 31% of the combined Companies total positions of 3,736. Approximately 252 corporate and administrative position reductions were identified by the Companies that could result from the consolidation of the Companies. This constitutes 22% of combined corporate and administrative positions, and 7% of the combined Companies' total positions. These reductions represent the anticipated level of functional duplication that would exist between the Companies and could be avoided through the creation of an integrated corporate and administrative organization.

Q. Please describe the results of the analysis discussed above.

A. As of January 1, 2000, BEC Energy is estimated to have a total of 2,230 positions in utility operations. As of that same date, COM/Energy is estimated to have a total of 1506 ~~1,108~~ positions devoted to utility operations. Those positions, which are field-related, are relatively unaffected for the purposes of the analysis. Examples of primarily unaffected positions include Distribution Department personnel or transmission transformer and substation maintenance crews. Thus, a large portion of the total positions that focus directly on service delivery to customers is not significantly affected by the merger and does not jeopardize safety, service quality or reliability.

In the analysis, BEC Energy had 706 positions associated with corporate and administrative functions, while COM/Energy had 463. The combined corporate and administrative positions of the two companies were thus 1,169, or 31 ~~35%~~% of the combined Companies total positions of 3776 ~~3,338~~. Approximately 252 corporate and administrative position reductions were identified by the Companies that could result from the consolidation of the Companies. This constitutes 22% of combined corporate and administrative positions, and 7 ~~8%~~% of the combined Companies' total positions. These reductions represent the anticipated level of functional duplication that would exist between the Companies and could be avoided through the creation of an integrated corporate and administrative organization.

BEC Energy also had 1,524 positions in field and field support functions such as distribution engineering, while COM/Energy had 1,043 positions in these categories. Approximately 110 reductions in positions performing these functions were identified by the Companies, which constitutes 4% of positions in these categories or 3% of total positions.

Q. What are the estimated total position reductions from the combination of the Companies?

A. Total position reductions are estimated at 362 or approximately 9.3% of total current combined company positions.

Q. When are these position reductions assumed to occur?

A. The Companies intend to achieve a number of these reductions by the beginning of the first year following completion of the merger. Due to the extensive integration of information systems applications that will be required in association with consolidating operations of the Companies, reductions in many functions will not be fully realized until the second or third years following completion of the merger.

Q. Once the potential position reductions were identified, how were the position reduction cost savings calculated?

A. Average salary levels were calculated by function and then applied to the identified position reductions in those respective areas. The average blended salary for the position reductions identified is estimated to be approximately $60,000 in 2000

BEC Energy also had 1,524 positions in field and field support functions such as distribution engineering, while COM/Energy had ~~645~~ 1,043 positions in these categories. Approximately 110 reductions in positions performing these functions were identified by the Companies, which constitutes ~~8~~ 4% of positions in these categories or 3% of total positions.

Q. What are the estimated total position reductions from the combination of the Companies?

A. Total position reductions are estimated at 362 or approximately ~~10.8~~ 9.3% of total current combined company positions.

Q. When are these position reductions assumed to occur?

A. The Companies intend to achieve a number of these reductions by the beginning of the first year following completion of the merger. Due to the extensive integration of information systems applications that will be required in association with consolidating operations of the Companies, reductions in many functions will not be fully realized until the second or third years following completion of the merger.

Q. Once the potential position reductions were identified, how were the position reduction cost savings calculated?

A. Average salary levels were calculated by function and then applied to the identified position reductions in those respective areas. The average blended salary for the position reductions identified is estimated to be approximately $60,000 in 2000 dollars based on the salary levels in 1998 for each company weighted by the number of resources in each company and then escalated one year.

Q. Are there cost savings associated with position reductions other than salary expense?

A. Yes. Benefit costs are also considered when determining the cost savings associated with position reductions. Benefits include such items as health insurance, life insurance, employee investment plans, pension expense, accruals for retirement health benefits of active positions, incentives and bonuses, payroll taxes and others. A blended benefits loading rate of 42.4% was used to estimate average aggregate benefits cost. The resulting total compensation including benefits averaged $85,000 in 2000 dollars.

Q. Was any portion of these corporate, field and field support staffing savings allocated to construction?

A. Yes. A certain portion of these expenses are capitalized rather than expensed annually, reflecting their relation to the capital or construction elements of the business. Capitalized amounts thus are recovered over the life of the asset to which these costs are assigned. A blended capitalization rate of 7.8% was used for corporate positions and 30.4% for field and field support positions based on the stand-alone expectations of each company weighted by relative size.

Q. How were cost savings calculated on the construction portion of corporate, field and field support staffing reductions?

A. The same method that I described previously for calculating cost savings related to avoiding capital expenditures was used. The annual fixed charge rates that I previously described were applied to the portion of position savings allocated to construction to convert these position savings to revenue requirements. The reduced revenue requirements represent the savings that result from the elimination of redundant construction-related activities.

Q. What were the total savings estimated to result from corporate, field and field support staffing consolidation?

A. The total corporate, field and field support position reductions were estimated to be 362 positions. The total cost savings from corporate, field and field support staffing for the ten-year period ending December 31, 2009, are estimated at $403 million.

Q. Could these position savings have been achieved without the merger?

A. No. The position reductions described are attributable to the merger. The reduction opportunities arise from overlap and duplication in functional performance, rather than from stand-alone initiatives unrelated to the merger. The savings discussed above are triggered by the opportunity to combine functions and eliminate redundancy, not by assumed improvements in operating efficiencies. Both Companies have ongoing continuous improvement programs in place, which have restrained cost levels and which are expected to continue. Attention was given to avoiding double counting these initiatives by excluding those pre-merger initiatives identified prior to 2000 from the beginning point position analysis. In addition, those continuing position reductions planned past-2000 were estimated and quantified and these annual amounts were then offset against potential savings to avoid capturing potential nonmerger impacts. The subject of premerger initiatives is discussed further elsewhere in this testimony.

2. Corporate and Administrative Programs

Q. What cost savings can be created through corporate program and expenditure consolidation?

A. The integration of corporate and administrative functions reduces certain non-labor costs, primarily through the consolidation of overlapping or duplicative programs and expenses.

Two examples, insurance and information systems expenses, will illustrate how these savings are created through a merger:

- Insurance - Cost savings typically would be realized in the areas of property insurance and excess general liability insurance, among others. On a stand-alone basis, each company carries insurance (or is self-insured) in these areas independently. A larger combined company will have a reduced risk profile because of its broader asset base. In addition, asset concentration will be less significant, which should translate into lower rates for the combined company.

- Information systems - Organizations must facilitate systems development and support the information processing needs of each company. Companies typically have independent plans to develop a variety of systems in the future, including parallel systems development efforts. A combination would enable the Companies to avoid incurring these duplicate capital expenditures. Additional information systems savings could result from deferred capital projects, such as mainframe upgrades or personal computer purchases. Additionally, savings could be realized from the elimination of other duplicate costs, including disaster recovery, software support, miscellaneous software and hardware, license fees, and computer maintenance.

Q. **What are the amounts, by specific area, of the corporate and administrative program savings?**

A. Savings were identified and quantified over the ten-year period in the following areas:

	Ten-Year Total ($000)
Administrative & General Overhead	17,424
Public Relations	8,773
Association Dues	2,398
Benefits	20,376
Credit Facilities	1,949
Facilities	42,263
Information Services	76,510
Insurance	16,091
Professional Services	22,568
Vehicles	1,028
Shareholder Services	1,716

Each of the aforementioned categories is described below.

a. Administrative and General Overhead

Q. What types of expenses are included in miscellaneous overhead expense and how are they affected by the merger?

A. Miscellaneous overhead expense includes, but is not limited to, periodicals, postage (other than customer billing), stationary, telecommunications, transportation and office supply expenses. These costs are variable with the total number of positions and change as the number of positions increase or decrease. As position reductions are achieved through the merger, miscellaneous overhead expenses also are reduced.

Q. How were estimated cost savings for this area quantified?

A. Miscellaneous overhead expenses were identified and separated between fixed and variable components and divided by the total positions for which they were applicable. The variable administrative and general costs for the Companies are incurred primarily by administrative and general ("A&G") positions, and therefore were reduced by A&G position impacts only. The combined average miscellaneous overhead expense per A&G position was then multiplied by total merger-related A&G corporate position reductions to arrive at a merger savings level for this area. The estimated merger savings identified were $17.4 million for the ten-year period.

Q. Could these miscellaneous overhead expense savings be achieved absent a merger?

A. No. These savings are directly related to the position reductions that would result from the merger.

b. Public Relations

Q. Please describe how public relations expenditures could be affected by the merger of the companies.

A. The merger gives rise to cost savings resulting from the elimination of duplicate fixed production (e.g., studio and distribution costs) and other program costs, as well as eliminated media costs in the overlapping territory.

Q. What is the level of savings estimated and how was this amount calculated?

A. The total estimated savings in the area of public relations over the ten-year period were $8.8 million. The savings reflect a reduction in the combined expenditures resulting primarily from the elimination of duplicative fixed production costs, local media buys and agency fees.

Q. Could the savings that have been identified in the public-relations area be achieved absent a merger?

A. No. These savings are predicated directly on the assumption that there is a single, combined company jointly identifying, developing and producing required public relations.

c. Association Dues

Q. Please describe how dues and memberships could be affected by the merger of the companies.

A. Both Companies are members of Edison Electric Institute ("EEI"). The combination will allow opportunities to realize an overall lower level of expenditures under the EEI formula compared to the expenditures under the formula on a stand-alone basis. These savings arise due to the declining unit rate applied in the two factors after initial threshold levels are met.

Q. How were savings in dues and memberships quantified?

A. A review of each company's industry and trade memberships was performed. A review for common organizations was conducted with overlapping memberships identified and the smaller expenditure was reduced or any formulaic calculations made to reflect the consolidation of memberships in these organizations. The resulting estimated savings identified were $2.4 million over the ten-year period.

Q. Could the savings in dues and memberships be achieved absent a merger?

A. No. They can be achieved only by consolidating memberships. Otherwise, there will continue to be two sets of memberships under separate formulas.

d. Benefits

Q. What levels of cost for administration of benefits programs are expected?

A. Estimates of total annual benefits costs for the Companies are approximately $17.3 million for BEC Energy and approximately $11.7 million for COM/Energy. These costs include medical, life insurance, pension and the administrative costs associated with those benefits programs. The estimated annual benefits administrative costs for the Companies are $1.1 million for BEC Energy and $0.8 million for COM/Energy.

Q. How can cost savings be achieved in the area of benefits and what are the estimated savings?

A. Benefits administration savings may be realized as a result of greater purchasing leverage for the combined entity when negotiating administration fees with third-party administrators. Additionally, purchasing leverage can be exercised in negotiating the dollar cost of benefits provided without reducing the level of benefits provided. The savings generated from the combination of the Companies were based on reducing benefit administration fees and benefit costs to reflect this purchasing leverage. Overall savings are approximately 4% of total costs to reflect this purchasing leverage. Savings in this area are expected to begin in 2001 to provide an adequate benefits plan redesign time frame with total savings of $20.4 million through the ten-year period.

Q. Could these savings be achieved absent a merger?

A. No. These savings are predicated directly on the assumption that there is a combined company under a single benefits package.

e. Credit Facilities

Q. Please describe how credit facilities could be affected by the merger of the companies.

A. The merger should allow the combination of the separate existing credit lines into one larger credit facility at an assumed lower percentage credit line fee when compared to the two existing separate credit facilities. The merger could also provide for the creation of a pool of funds available across both companies. Savings should be realized in negotiating the dollar cost of the combined credit line fees based on the expected facility requirements and the consolidation of commercial banking sources. Additionally, the combined company may be able to reduce its total line-of-credit requirements based on improved cash flows as a result of the synergies achieved in the combination. This reduction also may result in savings as the fees would be charged on a lower combined credit line.

Q. How were the savings in the area of lines-of-credit fees quantified?

A. Lines-of-credit fee reductions were calculated by reducing the total lines of credit of the combined company. The commitment fee percentages for the eliminated lines were multiplied by the total credit lines eliminated to arrive at the annual commitment fee reduction. The total savings for credit-line fees over the ten-year period was $1.9 million.

Q. Could these savings be achieved absent a merger?

A. No. These savings are predicated directly on the assumption that there is a single company with a lower credit line requirement than the two individual Companies would have in total.

f. Facilities

Q. What cost savings can be created through consolidation of corporate facilities?

A. Cost savings in this area are normally made possible by the nature and geographic location of the various corporate and field functions and facilities. Cost savings can be created through the consolidation of proximate business offices, service centers, warehouses and staging areas. Streamlining the work force also permits a reduction of total facilities as positions can be consolidated into fewer locations. Due to the geographic proximity between the operating utilities of BEC Energy and COM/Energy, certain of the support facility reduction opportunities, e.g., meter shops, warehouses, chemistry labs, etc. may also be available in this merger. Reconfiguration of the Southboro, Wareham, and corporate headquarters facilities was also assumed. Additionally, the reduced positions for headquarters-type functions provide an excellent opportunity to reduce total required headquarters square footage and avoid lease expenses. Both Companies are considering the